

SUPREME COURT OF THE STATE OF NEW YORK  
COUNTY OF NEW YORK

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PEOPLE OF THE STATE OF NEW YORK,  
by ERIC T. SCHNEIDERMAN, Attorney General of the  
State of New York,

Plaintiff,

- against -

J.P. MORGAN SECURITIES LLC, (f/k/a “Bear, Stearns &  
Co. Inc.”), JPMORGAN CHASE BANK, N.A., EMC  
MORTGAGE LLC (f/k/a “EMC Mortgage Corporation”),

Defendants.  
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Index No.:

**COMPLAINT**

Plaintiff Designates  
New York County as  
the Place of Trial

Plaintiff, the People of the State of New York, by ERIC T. SCHNEIDERMAN, Attorney  
General of the State of New York, alleges upon information and belief the following against  
Defendants J.P. Morgan Securities LLC (formerly known as “Bear, Stearns & Co. Inc.”),  
JPMorgan Chase Bank, N.A., and EMC Mortgage LLC (formerly known as “EMC Mortgage  
Corporation”) (collectively, “Defendants”).

**PRELIMINARY STATEMENT**

1. This action arises out of Defendants’ role in connection with the creation and sale  
of residential mortgage-backed securities (“RMBS”) to investors. RMBS were pools of  
mortgages deposited into trusts (“RMBS Trusts”). Shares of RMBS Trusts were sold as  
securities to investors, who were to receive a stream of income from the mortgages packaged in  
the RMBS.

2. Defendants committed multiple fraudulent and deceptive acts in promoting and  
selling its RMBS. For example, in publicly filed documents and in marketing materials,

Defendants led investors to believe that Defendants had carefully evaluated – and would continue to monitor – the quality of the loans in their RMBS. In fact, Defendants systematically failed to fully evaluate the loans, largely ignored the defects that their limited review did uncover, and kept investors in the dark about both the inadequacy of their review procedures and the defects in the underlying loans. Furthermore, even when Defendants were made aware of these problems, they failed to reform their practices or to disclose material information to investors. As a result, the loans in Defendants’ RMBS included many that had been made to borrowers who were unable to repay, were highly likely to default, and did in fact default in large numbers.

3. At the heart of Defendants’ fraud was their failure to abide by their representations that they took a variety of steps to ensure the quality of the loans underlying their RMBS, including checking to confirm that those loans were originated in accordance with the applicable underwriting guidelines, *i.e.*, the standards in place to ensure, among other things, that loans were extended to borrowers who demonstrated the willingness and ability to repay.

4. While the “due diligence” review that Defendants represented they undertook should have assessed the quality of the loans deposited into the RMBS, Defendants’ actual due diligence process was very different from their public representations about it. Defendants failed to use due diligence as a tool to identify and eliminate the many defective loans that they purchased from originators. Rather, and in order to preserve their relationships with loan originators, Defendants routinely overlooked defective loans that were identified through the due diligence review and ignored deficiencies that they knew existed in the due diligence review process itself. Furthermore, Defendants failed to disclose to investors the defects in the loans that they purchased and the deficiencies in their due diligence process. And despite being made

aware of the need to reform their review of the loans in their RMBS, Defendants made no efforts to improve the process. As an internal Bear Stearns document (dated July 2007) acknowledged, in addition to having “wide guidelines,” Defendants “abused the controls of them.” This, as the document put it, created a “perfect storm.”

5. Defendants also failed to respond properly to defects identified after securitization by their post-purchase quality control process. Defendants represented that this quality control process would result in the identification of problematic loans and their removal from Defendants’ RMBS. In reality, Defendants’ quality control department was so overwhelmed by the sheer number of defects in the underlying loans that it could not properly function. Defendants were aware that quality control was essentially unable to respond to the enormous numbers of problems in the underlying loans, but they did nothing to reform the process – and they failed to inform investors about the problems. Instead, Defendants used the quality control process to secure monetary recoveries for themselves, which they failed to pass on to investors.

6. Defendants’ misconduct in connection with their due diligence and quality control processes constituted a systemic fraud on thousands of investors. As a result of this fraudulent misconduct, investors were deceived about the fundamentally defective character of the mortgages underlying the RMBS they purchased. Mortgagors defaulted on their loans in exceedingly large numbers, causing the value of these securities to plummet, which in turn caused investors in RMBS to incur monumental losses.

## **THE PARTIES**

### **Plaintiff**

7. This action is brought by Attorney General Eric T. Schneiderman on behalf of the People of the State of New York. The Attorney General is charged by law with protecting the integrity of the securities marketplace in the State, as well as the economic health and well-being of investors who reside or transact business in the State. The Attorney General brings this enforcement action in the name of the People of the State of New York pursuant to Executive Law §§ 63(1) and (12) and the Martin Act (General Business Law Article 23-A).

### **Defendants**

8. J.P. Morgan Securities LLC, formerly known as J.P. Morgan Securities Inc. (“JP Morgan”) is a subsidiary of JPMorgan Chase & Co., which is a financial holding company incorporated in Delaware and principally located at 270 Park Avenue, New York, New York 10017.

9. At all relevant times, Bear, Stearns & Co. Inc. (“Bear Stearns”) was an SEC-registered broker-dealer and a subsidiary of The Bear Stearns Companies Inc. (“The Bear Stearns Companies”), principally located at 383 Madison Avenue, New York, New York 10179. Bear Stearns served as an underwriter for all of the securitizations at issue in this case.

10. At all relevant times, EMC Mortgage Corporation (“EMC”), a mortgage banking company incorporated in the State of Delaware as a wholly owned subsidiary of The Bear Stearns Companies, had its principal place of business at 2780 Lake Vista Drive, Lewisville, Texas 75067. Among other things, EMC purchased residential mortgage loans for securitizations, serviced these loans and sold these loans to investors. EMC acted as the sponsor

for all of the securitizations at issue in this case, including, but not limited to: the Bear Stearns Alt-A Trust, the Bear Stearns Asset Backed Securities I Trust, the Bear Stearns Asset Backed Securities Trust, the Bear Stearns Mortgage Funding Trust, the Bear Stearns Second Lien Trust, the SACO I Trust, and the Structured Asset Mortgage Investments II Trust.

11. On May 30, 2008, a wholly owned subsidiary of JPMorgan Chase & Co., merged with and into The Bear Stearns Companies, including Bear Stearns and EMC, becoming a wholly owned subsidiary of JPMorgan Chase & Co. in a transaction that was financed in part by a \$29 billion loan made by the Federal Reserve Bank of New York.

12. On or about October 1, 2008, Bear Stearns merged with an existing subsidiary of JPMorgan Chase & Co. known as J.P. Morgan Securities Inc. The resulting entity did business as J.P. Morgan Securities Inc. Effective September 1, 2010, J.P. Morgan Securities Inc. converted from a corporation to a limited liability company, and changed its name to J.P. Morgan Securities LLC (defined above as “JP Morgan”). Accordingly, all allegations against Bear Stearns are made against its legal successor, JP Morgan.

13. On or about March 31, 2011, EMC became a limited liability company, and now is registered in the State of Delaware as EMC Mortgage LLC. On or about April 1, 2011, JPMorgan Chase Bank, N.A., a subsidiary of JPMorgan Chase & Co., whose principal place of business is in New York, New York, acquired all or substantially all of EMC’s assets in a *de facto* merger. The inter-company asset sale of EMC’s loan servicing business did not result in a transfer of ownership of EMC’s assets, which remained with EMC’s and JPMorgan Chase Bank N.A.’s parent holding company JP Morgan Chase & Co. JPMorgan Chase Bank, N.A., succeeded to EMC’s business and assumed all of EMC’s rights and duties as servicer relating to

securitization transactions to which EMC is a party. JP Morgan Chase Bank, N.A., is liable for the conduct of EMC alleged herein.

14. At all relevant times, Defendants committed the acts, caused or directed others to commit the acts, or permitted others to commit the acts alleged in this Complaint. Any allegations about acts of the corporate defendants means that those acts were committed through their officers, directors, employees, agents, and/or representatives while those individuals were acting within the actual or implied scope of their authority.

### **JURISDICTION AND VENUE**

15. The State of New York brings this action pursuant to General Business Law § 352, *et seq.* (the Martin Act); Executive Law §§ 63(1) and 63(12); and in its sovereign and quasi-sovereign capacities as *parens patriae*.

16. Venue is proper in the Supreme Court of the State of New York, New York County because Defendants' actions originated in New York, New York, where Defendants conducted business. Moreover, numerous New York entities, as well as the interests of the State of New York and the City of New York were harmed by Defendants' conduct within the City and State of New York.

### **FACTUAL BACKGROUND**

17. This action is brought against Defendants in their role as sponsor and underwriter of subprime and Alt-A RMBS prior to the collapse of their business in 2008.<sup>1</sup>

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<sup>1</sup> A subprime mortgage is a type of loan normally extended to a borrower with lower credit ratings, while an Alt-A mortgage is typically one with a risk potential that is greater than a prime mortgage, but less than subprime.

18. RMBS represent interests in or “shares” of a pool of mortgage loans. Although the structure and underlying collateral varied, the basic principle of these securities remained the same: the cash flow from the pool of mortgage loans was “passed through” to the securities holders when payments were made by the underlying mortgage loan borrowers.

## **I. The Shift Away From An “Originate-to-Hold” Model**

19. Traditionally, mortgage loan originators financed their business through customer down payments, retained ownership of the loans they originated, and received the monthly mortgage payments themselves. Because these originators held mortgages through the term of the loan, they also bore the risk of loss if the borrower defaulted and the value of the collateral was insufficient to cover the cost of the loan. As a result, originators had a strong economic incentive to verify the borrowers’ creditworthiness through strict compliance with prudent underwriting guidelines and an accurate appraisal of the underlying property.

20. Between 1995 and 2005, the mortgage lending business shifted from an “originate-to-hold” model to what has been referred to as a “securitization machine,” in which originators no longer held mortgage loans to maturity, but rather sold them to banks for the sole purpose of securitization. Under this model, originators were paid when they sold mortgage loans, and bore none of the risk of non-payment. Instead, that long-term risk was transferred in large part to the investors in the securities.

21. Faced with the promise of immediate, short-term profits and no long-term risks, originators began to increase their volume of home loans without regard to prospective borrowers’ creditworthiness – including their ability to repay the loan. As the Federal Crisis Inquiry Commission (“FCIC”) concluded in its January 2011 report, this new “originate-to-

distribute” or “originate-to-securitize” model “undermined responsibility and accountability for the long-term viability of mortgages and mortgage-related securities and contributed to the poor quality of mortgage loans.”

22. In fact, numerous originators who were top contributors to Defendants’ RMBS were on the Comptroller of the Currency’s “Worst Ten” mortgage originators in the “Worst Ten” metropolitan areas due to their loans’ high rate of foreclosures during the period 2005 to 2007.<sup>2</sup> Many have been the subject of private and government lawsuits and investigations based on allegations of, among other things, their systemic abandonment of underwriting standards. Multiple witnesses – former employees of these originators – confirm these allegations and paint a clear picture of the pressure during these years to approve as many loans as possible. At least one of those originators – American Home Mortgage (“AHM”) – has also been implicated in a criminal matter. In March 2008, an AHM sales executive pleaded guilty to federal criminal charges of mortgage fraud. The sales executive admitted to intentionally inflating the income of a borrower on a loan application in order to get the loan approved, and further informed the Court at sentencing that he had been encouraged by AHM management to manipulate the loans in order to increase sales.

23. To underscore the originators’ pervasive failure to adhere to relevant guidelines and Defendants’ wrongful securitization of these noncompliant loans, some plaintiffs have even undertaken analyses of loan pools underlying Defendants’ RMBS. In its amended complaint against Defendants, for example, the Federal Housing Finance Agency (“FHFA”) analyzed

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<sup>2</sup> Plaintiff’s information about which originators contributed loans to Defendants’ RMBS comes from Prospectus Supplements, which were issued in connection with each securitization. These are imperfect sources of information, however, as they identify only those originators who contributed more than 10% of the loans in a particular loan pool. In this way, Defendants have thus far been able to avoid disclosing the existence of a particular originator’s contributions by limiting the loans from that originator to under 10%.



mortgage loans underlying the BSMF 2007-AR3 securitization (comprised of Alt-A collateral) and the BSABS 2006-AQ1 securitization (comprised of subprime collateral), among others. As FHFA's amended complaint alleges, the vast majority of loans in the samples reviewed – 523 of 535 loans from BSMF 2007-AR3 and 387 of 426 loans from BSABS 2006-AQ1 – did not meet the applicable guidelines.

24. The systemic abandonment of underwriting guidelines by the originators had a grave impact on the quality of loans that made their way into Defendants' RMBS, as evidenced by the dramatic rise in default rates on the loans underlying the RMBS. The common-sense conclusion – that high rates of delinquencies and defaults are evidence of faulty underwriting – finds support in a number of studies. For example, a Mortgage Fraud Report for 2006 by the Federal Bureau of Investigation ("FBI") linked the rate of mortgage payment delinquencies to, among other things, "high mortgage origination volumes that strained quality control efforts" and "the persistent desire of mortgage lenders to hasten the mortgage loan process." The FBI report relied in part on an analysis of three million loans conducted by BasePoint Analytics, which concluded that between 30% and 70% of early payment defaults<sup>3</sup> were linked to significant misrepresentations in the original loan applications, and that loans containing egregious misrepresentations were up to five times more likely to default in the first six months than loans that did not.

25. Largely as a result of these delinquencies and defaults, Defendants' RMBS have suffered tremendous losses. The current cumulative realized losses on over 100 subprime and

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<sup>3</sup> "Early payment defaults," or "EPDs," as defined in the U.S. Department of Housing and Urban Development Office's January 2010 Report to Congress on the Root Causes of the Foreclosure Crisis, are instances in which borrowers miss payments on newly originated loans.

Alt-A securitizations for which Defendants were the sponsor and underwriter in the years 2006 and 2007 alone are astounding. Those losses total approximately \$22.5 billion, or approximately 26% of the original principal balance of approximately \$87 billion.

26. In addition to experiencing extraordinary rates of delinquency, the credit ratings of these securities have been drastically downgraded. Today, many of the tranches in Defendants' RMBS have been downgraded from investment grade to "junk-bond" status.

## **II. Defendants' "Originate-to-Securitize" Approach Ignored Defects In The Underlying Loans**

27. Beginning in or about 2000, and continuing until 2007, Defendants actively sought to play a larger role in the RMBS market by dramatically increasing the volume of loans they purchased and securitized and touting their leading underwriter and market-maker role in residential mortgages.

28. Defendants generated loans for securitization through their own mortgage origination platform, Bear Stearns Residential Mortgage Corporation ("BSRMC"), and through a subprime mortgage originator, Encore Credit Corporation, which they acquired in or about early 2007. Directly participating in origination allowed Defendants "not only" to "secur[e] a permanent pipeline of product," but also "to control the quality of what [they were] creating."

29. In addition, EMC purchased loans for securitization from financial institutions and other secondary mortgage-market sellers. Beginning in or about 2001, Defendants formed a mortgage-loan conduit at EMC (hereafter, the "conduit"), which purchased loans for securitization through a bulk and a flow channel. "Bulk" acquisition involved the purchase of loans in bulk from large third-party originators. "Flow" acquisition involved smaller-scale

purchases of loans, typically on a loan-by-loan basis. Defendants often facilitated the origination and purchase of loans through both the bulk and flow channels by extending what was known as “warehouse” financing – essentially a line of credit – to originators with whom Defendants had a relationship. EMC’s affiliate, EMC Residential Mortgage Corporation (“EMCRMC”) provided credit to mortgage lenders through its warehouse lines of credit, as did BSRMC.

30. Defendants were aware that many of their loan originators were selling defective loans but continued to buy and securitize those loans. For example, according to a June 2006 internal Bear Stearns email, almost 60% of AHM loans that were purchased through the conduit were 30 or more days delinquent. After learning this information, Defendants went on to issue over 30 subprime and Alt-A securitizations that included AHM loans. At least four of these securitizations contained 30% or more loans originated by or purchased from AHM, including SACO I Trust (“SACO”) 2006-8, Structured Asset Mortgage Investments II Trust (“SAMI”) 2007-AR4, SAMI 2007-AR6, and SAMI 2007-AR7. Other internal communications reflect Defendants’ awareness of the bad quality of loans that were being included in other securitizations. In connection with the Bear Stearns Second Lien Trust 2007-1 (“BSSLT 2007-1”) securitization, for example, one Bear Stearns executive asked whether the securitization was a “going out of business sale” and expressed a desire to “close this dog.” In another internal email, the SACO 2006-8 securitization was referred to as a “SACK OF SHIT” and a “shit breather.”<sup>4</sup>

31. Defendants’ RMBS business was enormously profitable. In its public filings, The Bear Stearns Companies boasted throughout 2005, 2006 and 2007 of being a market leader in

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<sup>4</sup> Not surprisingly, the cumulative losses for these securitizations have been profound, amounting to over 75% of the original balance of BSSLT 2007-1 and over 43% of the original balance of SACO 2006-8.

mortgage-backed securitizations. In 2006, The Bear Stearns Companies ranked as the number one underwriter of mortgage-backed securities, capturing 11% of the overall U.S. mortgage securities market. The volume of EMC's securitizations grew exponentially between 2003 and 2006. In 2003, EMC securitized 86,000 loans valued at approximately \$21 billion. That number nearly tripled in 2004, to approximately 231,000 loans valued at \$48 billion. In 2005, the number jumped to approximately 389,000 loans valued at nearly \$75 billion. Finally, in 2006, EMC securitized over 345,000 loans valued at \$69 billion. From 2003 through 2006, EMC securitized over one million mortgage loans valued at the time in excess of \$212 billion.

32. Moreover, as a result of a “vertically integrated model” that generated revenue, as the FCIC noted, “at every step, from loan origination through securitization and sale,” Defendants took in money from a variety of sources, including: (i) loan fees on loans originated by Bear Stearns affiliates, including EMC and BSRMC; (ii) proceeds from the sale of RMBS to investors; (iii) fees from underwriting mortgage-backed securities; (iv) fees from servicing of the securitized loans; (v) fees from CDOs into which these securities were repackaged; (vi) gains and fees from trading in these securities and interest in the CDOs into which they were placed; and (vii) management fees and carried interest from hedge funds and other investment vehicles that invested in the vast array of securities and financial products structured by Defendants.

### **III. Defendants Made Material Misrepresentations To Investors About The Quality Of Their Due Diligence**

33. Defendants represented to investors that they had carefully screened the loans in their RMBS by subjecting them to an “intensive,” “prudent,” and “robust” due diligence process.

34. In publicly filed offering documents, moreover, including Prospectus Supplements (or “ProSupps”), Defendants represented that loan originators adhered to applicable

underwriting guidelines to assess borrowers' creditworthiness and to ensure the quality of the loans sold to Defendants. ProSupps for subprime and Alt-A securitizations issued by Defendants in 2006 and 2007, for example, typically represented that "[p]erforming loans purchased will have been originated pursuant to the sponsor's underwriting guidelines or the originator's underwriting guidelines that are acceptable to the sponsor." ProSupps also represented that the loans had been originated pursuant to underwriting standards designed to "evaluate the borrower's credit standing and repayment ability, and the value and adequacy of the mortgaged property as collateral," which it described as "consistent with those utilized by mortgage lenders generally" at the time. In instances where ProSupps noted that underwriting guidelines allowed for an "exception" to be made, the ProSupps made plain that such an exception would be pursuant to a deliberative course of action: some ProSupps represented that "compensating factors" were considered "on a case-by-case basis and at the sole discretion of senior management" or "credit management." Others stated that "exceptions" would be "managed" through "a formal ... process," while others indicated that the underwriters were "expect[ed] and encourag[ed] ... to use professional judgment based on their experience in making a lending decision."

35. Defendants' representations about the quality of the due diligence and of Defendants' efforts to ensure that the loans' adhered to applicable underwriting guidelines were false, and they were material to the reasonable investor in securities backed by such mortgages.

**A. The Mechanics of the Due Diligence Review Process**

36. Defendants hired specialized third-party firms to conduct due diligence reviews of bulk loan purchases. One of the largest of these firms (and one of the primary due diligence firms

used by Defendants) was Clayton Holdings (“Clayton”). The function of Clayton and other third-party due diligence providers was to “review closed loans and loan pools before they [were] purchased” so that the due diligence firm could “tell the clients whether the assets [met] their underwriting/compliance criteria or whether they need[ed] to be reviewed and repriced, or simply be rejected.”

37. The due diligence firms each followed similar review procedures. Defendants would choose a sample of a pool of mortgages for analysis by the firm. The manager of the due diligence team, known as the “Team Lead,” received the underwriting guidelines that the team was expected to apply, as well as any additional instructions that could override the guidelines. The due diligence team reviewed the loan files, often at the originator’s place of business, in accordance with Defendants’ instructions. In a typical review, the due diligence team would check for: (1) adherence to underwriting guidelines; (2) compliance with federal, state and local laws; and (3) the integrity of electronic loan data provided by the originator. These reviews were commonly referred to as “credit” and “compliance” reviews.

38. Loans received a grade following review. Loans that were graded “1” complied with underwriting guidelines; loans graded “2” “failed to meet guidelines” but were approved because of “compensating factors”; and loans graded “3” “failed to meet guidelines and were not approved.” If a loan was graded a 3 – *i.e.*, it failed to meet guidelines – and the defect could not be rectified, Defendants had to decide whether to “waive” the identified defect(s) and allow the loan to remain in the pool or, instead, to “kick” it out of the pool. Kicking out loans during due diligence could result in Defendants’ negotiating a new price for the loan pool. As a general matter, banks had full discretion to “waive” defects discovered by due diligence firms and to transform a grade of “3” to a “2” or “1.”

39. Once the grading process was complete, the due diligence firm provided Defendants with a final due diligence report. While this final report memorialized the due diligence firm's ultimate grade for each loan, it did not necessarily reflect what ultimately happened to those loans. Defendants retained the ability to include any loan in its securitization, regardless of the grade level assigned by the due diligence firm. Indeed, Defendants routinely bought loans that had been designated "Grade 3" by a due diligence firm.

40. Unlike loans purchased in bulk, flow loans were reviewed not by an outside firm, but by EMC employees. As the head of the EMC conduit stated to investors: "This guarantees we understand what we're buying before we buy it." Originators submitted the loans directly to EMC for review, and EMC underwriters were tasked with reviewing the loans for compliance with underwriting guidelines, including various data points such as credit score and income.

41. While an EMC underwriter could approve a loan for purchase without any review or approval from a supervisor or manager, the underwriter was not permitted to decline a loan without a manager's approval. When a loan failed to meet EMC's underwriting guidelines, an underwriter had the authority to approve it subject to certain conditions being satisfied, such as a receipt of missing documents from the originator. An underwriter could also recommend that a loan that failed to meet EMC's underwriting guidelines be declined, although such a decision would be subject to a second level of review by a Team Lead. Only a higher-level manager was authorized to reject a loan.

**B. Defendants Represented to Investors That They Would Apply a "Prudent" and "Intensive" Due Diligence Process to Screen the Loans in Their RMBS**

42. Defendants recognized that a sound due diligence practice was critical to assessing the quality of the Loans – indeed, it was the only way to determine whether loans

purchased from third-party originators conformed to the applicable guidelines. As the head of the EMC conduit stated: “Much of our management and control to ensure the quality of our business is provided through our due diligence process with the aid of a variety of technology tools and third party vendors.”

43. Moreover, Defendants were aware that investors had a keen interest in the subject of due diligence. According to a March 2005 email from the head of due diligence at Bear Stearns, investors were asking questions about the nature of Defendants’ due diligence process:

[o]ne of the things that has come up in meetings with bond investors ... is they want to know about the leads and teams that we use from our due diligence firms. They also are questioning if we are on site as the diligence occurs.

44. Defendants made numerous representations to investors about the quality of their due diligence and the loans’ adherence to underwriting guidelines in order to induce them to purchase their RMBS certificates.

45. In its annual report to shareholders, for example, Bear Stearns stated: “The Company generally performs due diligence on assets purchased and maintains underwriting standards for assets originated.” Similarly, other publicly filed documents, including ProSupps, assured investors that EMC’s operations “resemble those of most mortgage banking companies, except that significant emphasis is placed on the collection and due diligence areas, due to the nature of the mortgage portfolios purchased.”

46. Defendants also made representations about their due diligence in marketing materials disseminated to investors. These marketing materials were designed to convey to investors that Defendants implemented stringent protocols to ensure that their securities



contained quality loans. According to the testimony of a senior Bear Stearns executive, it was Defendants' intent that these presentations "contribute to the investor's decision to invest in the securitizations."

47. Defendant's marketing materials thus emphasized to investors that due diligence was "a critical component of conduit," *i.e.*, the entity through which Defendants purchased loans for securitization, and a means to "understanding ... risk upfront." They further described Defendants' due diligence practice as one that was "intensive," "prudent," and "robust." According to Defendants' marketing materials, the people who performed the due diligence reviews were of the highest caliber – referring to them, for example, as "[v]ery senior/experienced Deal Leads" and "seasoned staff underwriters" – and could provide "[c]omprehensive review[s] even in busy [quarter] ends."

**C. Far From Being "Intensive," "Prudent," and "Robust," Defendants' Due Diligence Process Systematically Ignored Problems In Order To Maximize Loan Volume**

48. Defendants' representations about their due diligence process were materially false and fraudulent. Rather than carefully reviewing loans for compliance with underwriting guidelines, Defendants instead implemented and managed a fundamentally flawed due diligence process that often, and improperly, gave way to originators' demands.

49. The due diligence process, as Defendants were well aware, was fundamentally compromised by the massive number of loans that Defendants sought to have reviewed in a short period of time. In addition, the need to maintain a relationship with originators – the number one client, according to the head of the EMC conduit – created a strong incentive for Defendants to limit the number of loans that were "kicked out" of a given pool. As the former President of

Clayton told the FCIC, Clayton's "clients," including Defendants, "often waived in loans to preserve their business relationship with the loan originator." He further acknowledged that "a high number of rejections might lead the originator to sell the loans to a competitor." Clayton's former Chairman and Chief Executive Officer confirmed this point when he admitted to the FCIC that if the bank "kicked out too many loans," it "wouldn't get invited to the next auction."

50. The due diligence providers, well aware of Defendants' need to maintain a relationship with the originators, conducted their loan review accordingly. In late 2006, for example, Clayton's due diligence review determined that a pool of bad quality SunTrust loans had "an 86% reject rate due to missing docs." Despite the high defect rate, a Clayton manager told a representative of SunTrust that "our number one priority is to help you get this Trade cleared up and funded" – *i.e.*, make sure Defendants' purchase of the loans went through. This communication shows that even when Clayton saw that the vast majority of a loan pool was defective, its approach to due diligence was, as one former Clayton Team Lead put it, not to "upset the apple cart."

51. As a result, bulk due diligence review in the years prior to Defendants' collapse did not involve a "robust" or "intensive" examination of loan files. Instead, the due diligence underwriter's function was essentially to enter data into a computer system from documents in a loan file. Due diligence reviewers were directed not to spend too much time on a loan (or not to "get married to" the loan), and were rewarded for reviewing loans quickly. They were reminded that the loans were already "closed," and that the borrowers had already moved into their homes. In other words, due diligence reviewers were made to understand that because the loans could not be undone, a thorough reevaluation of loan quality was unnecessary, and even pointless.

52. During this time frame, Clayton's paramount objective was to get the review job done as quickly as possible for its clients. Clayton executives established aggressive daily "productivity" goals. Underwriters who did not maintain the requisite pace of review received warnings from their supervisors and faced the very real prospect of dismissal. As one Team Lead stated in an e-mail: "Have 1594 loans to do in 5 days. Sound like fun? NOT!"

53. To accommodate this massive volume of loans, Defendants' due diligence process abandoned certain basic inquiries – such as determining the reasonableness of income in a "stated income" loan. According to dozens of former due diligence firm employees and EMC underwriters, the very high volume of "stated income loans," and their limited ability to probe the reasonableness of the income stated, was one of the greatest challenges of the due diligence review. A loan analysis undertaken by FHFA in connection with its civil action against Defendants and others concluded that "a significant number of mortgage loans" in some of Defendants' securitizations "were made on the basis of 'stated incomes' that were patently unreasonable, and were not properly underwritten through efforts to assess the reasonableness of the borrowers' stated incomes."

54. Defendants were well aware that stated income loans – despite being an area of great concern in the industry – were not closely scrutinized. The head of due diligence at Bear Stearns himself acknowledged that prior to 2007, stated income loans were not "looked at ... as hard," and that, even in 2007, he was not aware of any process in place to verify employment for stated income loans either at Bear Stearns or its due diligence providers.

55. The review of loans that Defendants purchased through the flow channel was equally superficial and focused on quantity at the expense of quality. EMC underwriters were

typically required to underwrite fifteen to twenty loan files per day, and the pressure to review this high volume of loans often came in second half of the month if the volume of funded loans was not on track to meet the monthly target.

56. Indeed, Defendants' internal documents reveal that its senior traders put inordinate pressure on EMC staff to acquire and securitize an enormous quantity of loans. As an EMC underwriting manager wrote to her staff:

I refuse to receive any more emails from [a Bear Stearns Senior Managing Director] (or anyone else) questioning why we're not funding more loans each day. . . . [I]f we have 500+ loans in this office *we MUST find a way to underwrite them and buy them.* . . . I was not happy when I saw the funding numbers and I knew that NY would NOT BE HAPPY. . . . I expect to see 500+ each day. ... I'll do whatever is necessary to make sure you're successful in meeting this objective.

(Emphasis added.)

57. To drive home the point, that same manager stressed to her staff that EMC "hit the target number," which was a funding volume of \$2 billion for that month. In other words, EMC had to underwrite and purchase \$2 billion worth of mortgage loans in a single month. Multiple confidential witnesses, former employees of EMC, have confirmed Defendants' "whatever is necessary" approach to achieve aggressive volume goals.

58. As the volume of loans acquired by EMC through its flow channel increased dramatically, Defendants took measures to expedite their loan review, which had the effect of reducing the amount of due diligence for originators in certain designated "tiers." For example, EMC divided its flow channel sellers into five tiers based on the volume and the estimated quality of the loans supplied to EMC, and performed "streamline," or abridged, reviews for loans from certain of these sellers. Moreover, as mentioned above, the review process itself – which gave

underwriters and Team Leads discretion to approve but not to reject loans – was set up so as to make approval of a loan the path of least resistance.

59. This and other evidence demonstrates that, through their singular focus on increasing loan volume, Defendants sacrificed thorough due diligence – that is, the rigorous review of the loans that they told investors they undertook – and thus acquired and securitized loans without ensuring loan quality or adequately assessing the borrowers’ ability to repay.

**D. Defendants Often Ignored Due Diligence Firms’ Findings of Defects**

60. Even Defendants’ watered-down due diligence review could not help but identify a large number of problematic loans. Rather than rejecting or replacing those loans, however, the Defendants routinely ignored the defects.

61. In or about 2006, Clayton began tracking exceptions and waivers by clients, including Defendants. According to a report prepared by Clayton as part of this effort, during the period first quarter 2006 to second quarter 2007, approximately 16% of the loans that Defendants submitted to Clayton for review were deemed by Clayton to violate applicable underwriting guidelines and received a grade of “3.” That same report reflects that Defendants subsequently overrode close to half of those “3” grades. In fact, as another report provided by Clayton to Plaintiff shows, Defendants disregarded Clayton’s findings of defective loans up to 65% of the time in the third quarter of 2006 alone. A “Bear Stearns / EMC Trending Report Executive Summary” prepared by Clayton in May 2007 represents that “Stated Income not Reasonable” was

“[t]he most common waived exception in 2007.”<sup>5</sup>

62. Defendants were aware that their approach to due diligence, including the severe time constraints they placed on reviewers, resulted in deficient loan reviews. Nonetheless, Defendants failed to fix the problem. Defendants further failed to inform investors as they became aware of defects in their due diligence process and never disclosed their failure to improve that process.

63. As early as 2005, the head of Bear Stearns’ due diligence department began to request that senior management revise due diligence protocols. In an April 2005 email, for example, he proposed “New Due Diligence Processes” that included identifying “higher risk loans within sample to [due diligence] firms so that more seasoned [underwriters] are reviewing those loans.” He also proposed ranking loans by risk criteria and applying incrementally greater resources to the review of each successive gradation of loan: “We should ... identify the top 25% of loans within the sample that we feel pose the largest risk potential. Both Clayton and PWC [another due diligence firm] upon having those loans tagged/identified can place their most seasoned underwriters to review the loans and also perform additional QC on those loans. Both of these processes are ones that we can use to market our process to investors and the rating agencies going forward.” While the head of due diligence asserted that this proposal was implemented, he could not state when or give any details, stating only that “it took us a long time to generate process...”

64. In fact, no significant changes were made. Two years later – and with Bear

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<sup>5</sup> Plaintiff’s own preliminary analysis shows a high waiver rate. For example, with respect to 32 loan pools that were reviewed by Clayton for Defendants during the first quarter 2007, the average waiver rate was 35.7%. These waivers included loans that had been graded “3” on the basis of unreasonable stated income, including one stated income loan for a borrower who, as a manager of the fast food restaurant Baja Fresh, claimed to make \$7,000 a month.

Stearns' collapse just a year away – the head of due diligence again made a very similar proposal to revise the due diligence process, stating the need to “determine the type of diligence to be done” based on the loan’s “risk score,” with “[t]he highest level of risk” getting “the most comprehensive review.” At this desperate stage, he underscored the need “to completely revamp how we do due diligence.”

65. Defendants did not disclose to investors their serious and long-standing concerns about the quality of their due diligence reviews or that they were severely compromising their due diligence process in order to increase their volume of securities. Nor did Defendants take any significant steps prior to 2007 to adopt internally-recommended proposals to correct perceived deficiencies in the system. Instead, Defendants permitted the critical problems that their own employees had identified in 2005 to continue throughout 2006 and into 2007.

66. Indeed, far from making an effort to improve their due diligence review – and thereby improve the scrutiny of the loans they were purchasing – Defendants, as early as February 2005, began to *reduce* the amount of due diligence conducted “in order to make us more competitive on bids with larger sub-prime sellers.” As one senior executive acknowledged in testimony, the “reduction in due diligence could be a response to a request from a seller.” Furthermore, in certain instances, Defendants began conducting due diligence only *after* the loans were purchased, instead of before. These changes undermined the effectiveness of the due diligence process.

67. Defendants were well aware of the obvious negative repercussions of these changes. In connection with March and June 2006 bulk purchases from AHM, for example, the head of due diligence told a senior executive that he “strongly discourage[d]” an agreement to

conduct “post close due diligence” and warned: “You will end up with a lot of repurchases.” Defendants nevertheless proceeded to purchase the two loan pools and packaged over 900 loans into securities. This was not an isolated problem. In March 2006, a Bear Stearns deal manager observed that Bear Stearns completely failed to keep track of the due diligence performed on loans purchased through the flow channel, stating that “on the flow side we had no idea until yesterday that there was post close [due diligence] going on. . . . I agree that flow loans were not flagged appropriately and we securitized many of them which are still to this day not cleared. I think the ball was dropped big time on the flow processes involved in the post close [due diligence], from start to finish.”

68. This weakened due diligence process came at a time when stringent controls were most necessary. By weakening their due diligence processes, Defendants ignored – and essentially condoned – severe defects in the loans that they purchased and securitized.

69. By the end of 2006, RMBS traders at other banks were beginning to hear “rumors of a credit meltdown at [Bear Stearns],” as a trader at one firm told a trader at another firm in an electronic message dated November 30, 2006. According to the trader who had heard the rumor, the “precise description” of Bear Stearns’ state at that time was “def co[n] 3” – or “defensive condition 3” – the military term signifying a heightened state of alert. The trader sharing the “rumors” then pointedly remarked: “little due diligence upfront makes for a bad day 12 months later.”

#### **IV. Defendants’ Post-Purchase Quality Control Process Benefited Originators at the Expense of Investors**

70. Defendants operated a quality control (“QC”) department tasked with reviewing loans after they were purchased, *i.e.*, “post settlement.” The QC review consisted of re-



verification of certain credit information, including assets, employment and occupancy, as well as a review of referrals of 90+ day delinquent loans from the servicer. The QC department used various tools and outside vendors to detect borrower fraud and determine property values. The stated goal of QC was to detect any red flags and determine whether the loans complied with underwriting guidelines. As Defendants' marketing materials represented: "We utilize our intensive QC and analysis to develop strategies that lead to improved performance."

71. The QC department consisted of several groups. One of those, the "claims" group, was responsible for, among other things, monitoring the loans in EMC's inventory for early payment defaults (EPDs) – that is, loans that became delinquent in the first thirty to ninety days after origination – to determine whether any of the representations and warranties had been breached. Once a breach was identified, it was also the job of the claims department to request that the originator of the loan repurchase the loan or otherwise settle the claim.

72. Defendants' QC department failed in its stated purpose to identify and eliminate defective loans that made their way into securitizations. Because of severely deficient pre-purchase underwriting, and the resulting purchase and securitization by Defendants of defective loans, the QC department was overwhelmed to the point of "crisis." In addition, even when the QC department did identify serious problems, it failed to remove defective loans from the securitizations. Instead, Defendants entered into confidential settlements with originators of these toxic loans at a fraction of their price, without repurchasing them from the securitizations. Defendants thus ensured a continuing supply of loans for later securitizations, while enriching themselves and the originators to the detriment of the unsuspecting investors.

**A. The Growing Volume of Defective Loans Incapacitated Defendants' QC Department**

73. Due in large part to the defective loans Defendants purchased and securitized, by at least 2006, Defendants' QC operations could no longer keep pace with the overwhelming number of claims that needed to be filed. According to a February 28, 2006, internal audit report that was distributed to senior management, as of October 2005 there was "a significant backlog for collecting from and submitting claims to sellers." The backlog consisted of at least 9,000 outstanding claims valued at over \$720 million. The report recommended that "[p]olicies ... be developed and procedures enhanced to ensure that claims are processed and collected in a more timely manner."

74. Despite their awareness of deficiencies in the claims recovery process, Defendants did little to fix the problem. As a senior executive observed months later, the "[c]laims situation continues to be a disaster – hitting crisis," because "our operation cannot support the claims collection methodology we have been trying to pursue."

75. Defendants did not disclose to investors that their QC function was "overwhelmed" to the point of being in "crisis" and did not operate, as advertised, in a manner that would work to investors' benefit.

**B. Defendants Breached Their Obligations to Repurchase Defective Loans From Securitizations While Secretly Settling Claims with Originators and Pocketing Recoveries**

76. Although loan originators were contractually required to buy back defective loans at an agreed-upon repurchase price, Defendants routinely permitted them to avoid this obligation by extending cheaper or otherwise more appealing alternatives. Specifically, Defendants offered substantial concessions to originators in order to preserve Defendants' relationships with them

and to ensure the continued flow of loans.

77. For example, “in lieu of repurchasing the defective loans,” originators were permitted by Defendants to confidentially settle EPD and other claims by making cash payments that were a fraction of the contractual repurchase price. Defendants’ other concessions included agreements to cancel or waive entire claims against originators, and the creation of “reserve programs” under which Defendants used funds collected from these originators towards future loan purchases.

78. According to an internal presentation, during the period May 2006 to April 2007 alone, Bear Stearns resolved \$1.9 billion worth of claims against sellers relating solely to EPDs. As a further accommodation to originators, Defendants also agreed to extend the EPD period so that already-securitized loans that had defaulted during the designated EPD period, and then started paying again, could remain in the securitization. This allowance was made despite Defendants’ recognition that an EPD is a strong indicator not only of a borrower’s inability to repay but also of fraud in the origination. Notably, Defendants’ extension of the EPD period applied only to securitized loans; extensions of the EPD period for loans in Defendants’ own inventory were expressly forbidden.

79. Defendants were contractually obligated to give prompt notification to investors of any breach that materially and adversely affected investors, such as fraud in connection with loan origination or the failure to underwrite a loan in accordance with underwriting guidelines. Defendants were also required to repurchase defective loans from securitizations. Defendants not only failed to fulfill their contractual obligations; according to the testimony of one senior Bear Stearns manager, Defendants collected and retained the recoveries they obtained from their

undisclosed settlements with originators.

80. Defendants kept settlement amounts for themselves rather than depositing the settlements into the relevant RMBS trusts, and failed to disclose that they were recovering and pocketing money from originators for settled EPD claims on loans that remained in their RMBS Trusts. Defendants also failed to further investigate whether any of the settled claims based on EPD, which could be a sign of fraud at origination, also constituted a securitization breach.

81. Defendants' own lawyers advised Defendants that EPD loans that were subject to settlements had to be reviewed for representation and warranty breaches and that Defendants could no longer keep for themselves the substantial monetary recoveries obtained on their EPD and other claims relating to securitized loans. Similarly, Defendants' external auditor, PriceWaterhouseCoopers ("PWC"), in August 2006, advised Defendants to stop asserting EPD claims against sellers on securitized loans before determining whether a breach of representations and warranties of securitization agreements also existed, suggesting the inappropriateness of allowing defective loans to remain in the securitizations while at the same time collecting monies from originators in connection with those loans. PWC also advised Bear Stearns to begin the "[i]mmediate processing of the buy-out if there is a clear breach in the PSA agreement to match common industry practices, the expectation of investors, and to comply with the provisions in the PSA agreement." PWC further advised Bear Stearns to remedy, among other things, its "[l]ack of repurchase related policies and procedures in the Claims [department]" in order to comply with SEC regulations that became effective at the beginning of 2006. In fact, Defendants had no protocols in place to assess defective loans from the conduit for securitization breaches until 2007.

## **CLAIMS**

### **FIRST CAUSE OF ACTION**

#### Securities Fraud – General Business Law Article 23-A

82. The Attorney General repeats and re-alleges paragraphs 1 through 81 as if fully set forth herein.

83. The acts and practices of Defendants alleged herein violated Article 23-A of the General Business Law in that Defendants employed deception, misrepresentations, concealment, suppression, fraud and false promises regarding the issuance, exchange, purchase, sale, promotion, negotiation, advertisement and distribution of securities.

### **SECOND CAUSE OF ACTION**

#### Persistent Fraud or Illegality – Executive Law § 63(12)

84. The Attorney General repeats and re-alleges paragraphs 1 through 81 as if fully set forth herein.

85. The acts and practices alleged herein constitute conduct proscribed by § 63(12) of the Executive Law, in that Defendants engaged in repeated fraudulent or illegal acts (in violation of, *inter alia*, the Martin Act) or otherwise demonstrated persistent fraud or illegality in the carrying on, conducting or transaction of business.

**WHEREFORE**, Plaintiff demands judgment against Defendants as follows:

A. Enjoining and restraining Defendants, their affiliates, assignees, subsidiaries, successors and transferees, officers, directors, partners, agents and employees, and all other persons acting or claiming to act on their behalf or in concert with Defendants, from engaging in any conduct, conspiracy, contract, or agreement, and from adopting or following any practice,

plan, program, scheme, artifice or device similar to, or having a purpose and effect similar to, the conduct complained of above;

B. Providing an accounting of all fees, revenues, or other compensation received, directly or indirectly;

C. Directing that Defendants disgorge all amounts obtained in connection with or as a result of the violations of law alleged herein, all moneys obtained in connection with or as a result of the fraud alleged herein, and all amounts by which Defendants has been unjustly enriched in connection with or as a result of the acts, practices, and omissions alleged herein;

D. Directing that Defendants pay damages caused, directly or indirectly, by the fraudulent and deceptive acts complained of herein, plus applicable pre-judgment interest;

E. Directing that Defendants make restitution of all funds obtained from investors in connection with the fraudulent and deceptive acts complained of herein;


F. Directing that Defendants pay Plaintiff's costs, including attorneys' fees as provided by law;

G. Directing such other equitable relief as may be necessary to redress Defendant's violations of New York law; and

H. Granting such other and further relief the Court deems just and proper.

Dated: October 1, 2012  
New York, New York

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